Petition

81-1533

Office - Supreme Court, U.S.
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ALEXANDER L. STEVAS,
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

MERCHANTS REFRIGERATING COMPANY
OF CALIFORNIA,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

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(12032)

QUESTIONS PRESENTED

I. Did the Court of Appeals err in refusing to consider a subsection of the Internal Revenue Code when the entire section was pleaded in the complaint as grounds for relief?

II. Did the Court of Appeals err in refusing to consider whether the petitioner's facilities were "giant refrigerators" eligible for the investment credit under 26 U.S.C.A. § 48(a)(1)(A) on the ground that the point was not raised in the lower courts, when in fact such point was raised?

III. Did the Court of Appeals err in refusing to follow its own precedent of granting relief provided for by a provision of the Internal Revenue Code not raised in the lower court but which applied to the facts in the case?

IV. Was a conflict created by this Court of Appeals in not following the

Court of Appeals for the Fourth Circuit, which reversed the Tax Court because it failed to apply certain sections of the Internal Revenue Code applicable to the facts established in the Tax Court even though such provisions were not pleaded in that case?

V. Did the lower court err in finding that retention of control by the owner of goods stored in a public facility changed "fungible goods" into "non-fungible goods" when there was no such requirement set forth in the Internal Revenue Code, Congressional Reports or in the Regulations of the Commissioner of Internal Revenue?

VI. Did the lower courts err in applying such limitations when there was only one owner storing goods at the facility?

VII. Did the Court of Appeals err in applying the "clearly erroneous" rule to

a question of law?

VIII. Did the Court of Appeals err in not reversing even though it found error in the Court below?

The parties in the District Court and Court of Appeals were Merchants Refrigerating Company of California (California) and the United States. Merchants Refrigerating of California was a wholly owned subsidiary of Merchants Refrigerating Company (New York) which was a wholly owned subsidiary of Pet, Incorporated (Delaware), which was a wholly owned subsidiary of I C Industries, Inc. (Delaware). Title to the facilities in question was conveyed in October, 1981 to Merchants Refrigerating Company (Delaware), a wholly owned subsidiary of Christian Salvesen, Ltd., (United Kingdom). Any refund of taxes hereunder will inure to the benefit of Pet, Incorporated.

TABLE OF CONTENTS

	Page
Questions Presented	1
Table of Authorities	v
Opinions Below	1
Jurisdiction	2
Statute	3
Statement of Case	4
Reasons for Granting the Writ	14
I. The lower courts should have considered the entire applicable provisions of the Internal Revenue Code.	15
II. The lower courts refused to consider a provision of the Internal Revenue Code although pleaded.	15
III. The Circuit Court refused to follow its own precedents.	17
IV. The Circuit Court is in conflict with the Fourth Circuit.	20
V. The lower courts erred in its definition of "fungible goods".	21

VI. Retention of control does not destroy fungibility. 24

VII. The Circuit Court should not have applied the "clearly erroneous" rule. 25

VIII. The Circuit Court should have reversed after finding error. 29

Conclusion 30

Appendix A - Opinion of Circuit Court A-1

Appendix B - Order of Circuit Court denying rehearing B-1

Appendix C - Memorandum Decision of District Court C-1

Appendix D - Judgment of District Court D-1

TABLE OF AUTHORITIES

Cases

Ah Pah Redwood v. Commissioner, 251 F. 2d 163 (9th Cir., 1957) 17,18,20

Allen v. United States, 541 F. 2d 786 (9th Cir., 1976) 28

Catron v. Commissioner, 50 T.C. 306 (1968) 16

Central Citrus Co. v. Commissioner, 58 T.C. 365 (1972) 16,17

Commissioner v. Duberstein, 363 U.S. 278 (1960) 27

Cooper v. Commissioner of Internal Revenue, 197 F. 2d 951 (4th Cir., 1952) 20

Parkside v. Commissioner, 571 F. 2d 1092 (9th Cir., 1977) 26

Redwood Empire Savings & Loan Assn. v. Commissioner, 628 F. 2d 516, 521 (9th Cir., 1980) 18, 20

Thompson v. Commissioner, 631 F. 2d 642 (9th Cir., 1980) 27

United States v. Patrin, 575 F. 2d 708, 712 (9th Cir., 1978) 18

United States v. United States Gypsum Co., 333 U.S. 364 (1948) 28

Statutes

26 U.S.C.A. 38 4, 22

26 U.S.C.A. 48 3,4,15

26 U.S.C.A. 48 (a)(1)(A) 3,15,16,17

26 U.S.C.A. 48 (a)(1)(B) (i) and (iii) 3,4,15

Rule 52 (a) Fed. Rules Civ. Proc. 28 U.S.C.A. 25

Committee Report

Senate Committee Report (92d Cong. 1st Sess. Rep. No. 92-437(1971)26) 22

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1981

No. _____

----------X

MERCHANTS REFRIGERATING COMPANY OF CALIFORNIA,

Petitioner,

- v -

UNITED STATES OF AMERICA,

Respondent.

----------X

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in this case on October 13, 1981.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit

affirming the decision and judgment of the United States District Court for the Eastern District of California was made on October 13, 1981. (659 F.2d 116). This opinion is included as Appendix A.

The opinion of the United States District Court for the Eastern District of California granting summary judgment for the respondent was made March 2, 1979 is unreported, and is included as Appendix C. The judgment of the District Court was entered on April 19, 1979 and is included as Appendix D.

JURISDICTION

The judgment of the United States Court of Appeals for the Ninth Circuit was entered on October 13, 1981, a timely petition for a rehearing was filed and an Order denying the petition was filed November 25, 1981, a copy of which is included as Appendix B.

This Court has jurisdiction pursuant to

28 U.S.C. § 1254 (1).

STATUTE

The pertinent provisions of the Internal Revenue Code are 26 U.S.C.A. § 48(a)(1)(A) and (B) are as follows:

(a) Section 38 property

(1) In general -- Except as provided in this subsection, the term "section 38 property" means --

(A) tangible personal property (other than an air conditioning or heating unit), or

(B) other tangible property (not including a building and its structural components) but only if such property --

(i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water,

or sewage disposal services, or . . .

(iii) constitutes a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state) . . .

STATEMENT OF THE CASE

In the District Court, petitioner claimed an investment credit for certain depreciable property as allowed by 26 U.S.C.A. 38. The District Court found that such property did not meet the requirements of 26 U.S.C.A. 48, and thereby denied such relief. This decision was affirmed by the Court of Appeals for the Ninth Circuit.

Petitioner is a California corporation filing its income tax returns on a March 31 fiscal year basis. It provides

refrigerated storage facilities for food processors in Modesto and Salinas, California.

During fiscal 1973 petitioner constructed a one-story cold storage facility in Modesto, identified as Building "F" addition, an extension of an existing building "F". The addition consisted of three separate areas. The main part of the addition was a fully enclosed freezer room with 23,162 square feet of refrigerated area; an enclosed non-refrigerated truck dock of 3,913 square feet and an enclosed rail dock of 3,325 square feet. It cost $267,075 to construct exclusive of machinery and equipment.

Also during fiscal 1973 petitioner constructed a one-story cold storage facility identified as "Building 3" in Salinas. The building consisted of three separate areas. The main part was a fully enclosed freezer with 39,427 square feet of

refrigerated area; a warehouse office of 1,483 square feet and a canopy covered truck dock of 17,058 square feet. It cost $664,987 to construct exclusive of machinery and equipment.

During fiscal 1974 petitioner constructed a one-story cold storage facility identified as "Building 4", located in Salinas. The building consisted of a fully enclosed freezer area of 41,787 square feet and a canopy covered truck dock area of 10,055 square feet. It cost $316,096 to construct exclusive of machinery and equipment.

Each of these structures is used exclusively to store frozen perishable commodities. No processing or packaging activities whatsoever are carried on therein.

They were each depreciable and had a useful life of over four years. It is the construction of these three facilities

that form the basis of this action.

Processors use three methods to prepare food for storage in the petitioner's facilities. In each operation, the product is initially received by the processor in its raw state. It is cleaned, graded, processed and then frozen.

Under the first method of preparation, known as belt freezing, the unfrozen product is poured from the processing line onto a mesh belt. As it is conveyed along this belt, extremely cold air is forced up from underneath the food causing it to float on top of the belt while simultaneously freezing it individually. Thus, peas treated in this manner would be separately frozen and loose flowing as they reach the end of the belt. From there the foods are poured into tote bins or other large containers such as a 50-pound carton.

Tote bins are 4'x4'x4' in size. After being stamped or tagged with a description of the product, its grade, warehouse lot number and the name of the packer, owner, or distributor, the tote bins are removed from the processor's premises by forklift trucks and delivered to petitioner's freezer room. A particular lot may consist of several thousand tote bins. When the processor later decides to package some of the commodities, it will requisition a certain number of tote bins. Petitioner selects those bins closest to the aisle where they are stacked and delivers them to the processor or its assignee. Thus, within any given lot, any tote bins may be delivered to the person requistioning less than the entire lot. In addition, tote bins containing the same commodity may be stored under several lot numbers. At times, the processor will requisition

all the lots containing the same commodity and, upon their delivery to the rewrap shed, will commingle the contents prior to placing the food in small consumer packages.

At Modesto, almost all of the food is placed into tote bins after freezing and is stored in Building "F", which contains products owned only by John Inglis Frozen Food Company or its assignees.

Not all commodities are amenable to belt freezing. Vegetables such as spinach cannot be frozen separately, but must be packaged and then frozen in one solid mass within the container. For this, the processor will clean, grade, cut and package the commodity usually in 10 ounce cartons and then label them. The unfrozen packages are put on freezer racks which in turn are placed in a blast freezing tunnel. Air at -35° F. is forced through the tunnel for three to four

hours to freeze the packages. Thereafter the commodities are taken to the petitioner's freezer room where they are stored on pallets by lot number. From time to time, packages with one label may be needed to fill the needs of a different distributor; the processor will remove the labels and relabel them with the appropriate name.

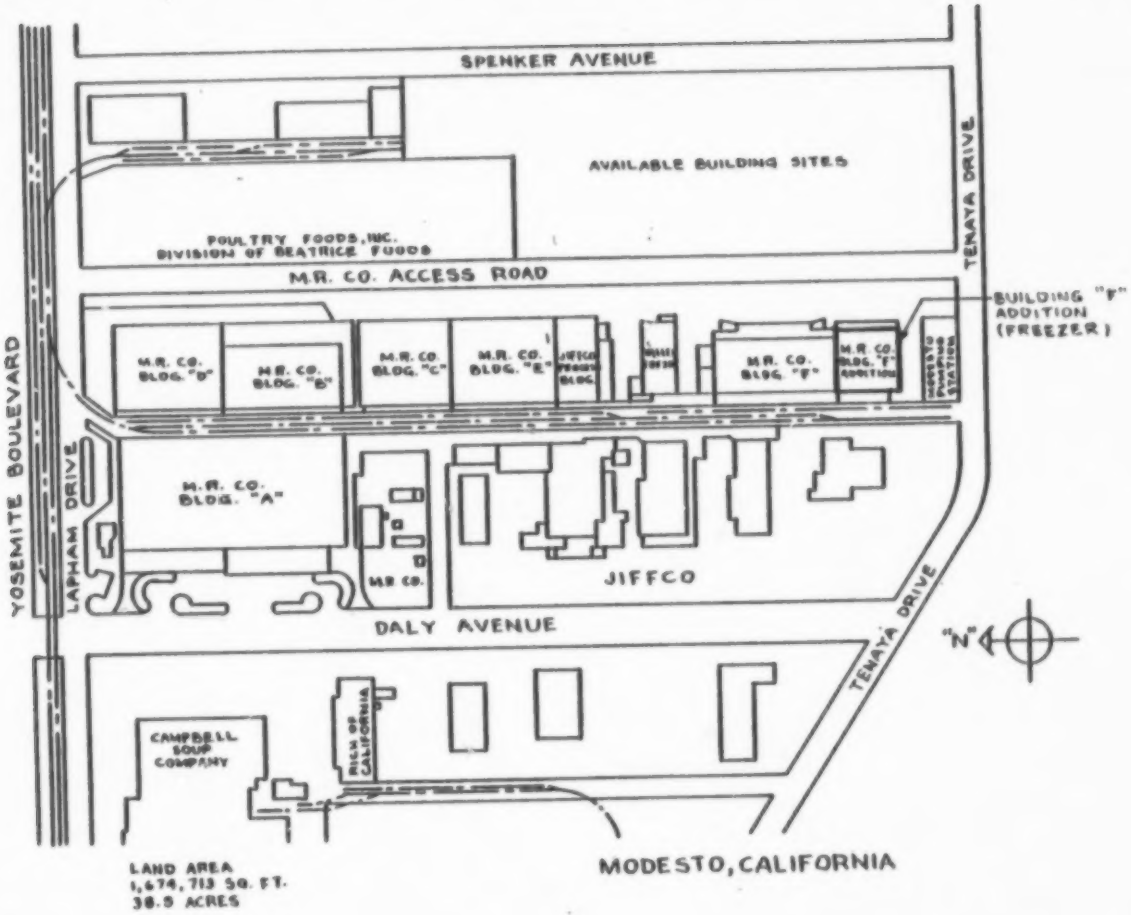
The third method of freezing is called plate freezing. It is similar to blast freezing in that the product is packaged in consumer sized packages and labeled as soon as it comes off the processing line. The packages are placed on a refrigerated shelf where they remain until they are frozen. From there, they are placed in larger packing crates, taken to the freezer room and stored by lot number and the name of the distributor, owner or packer.

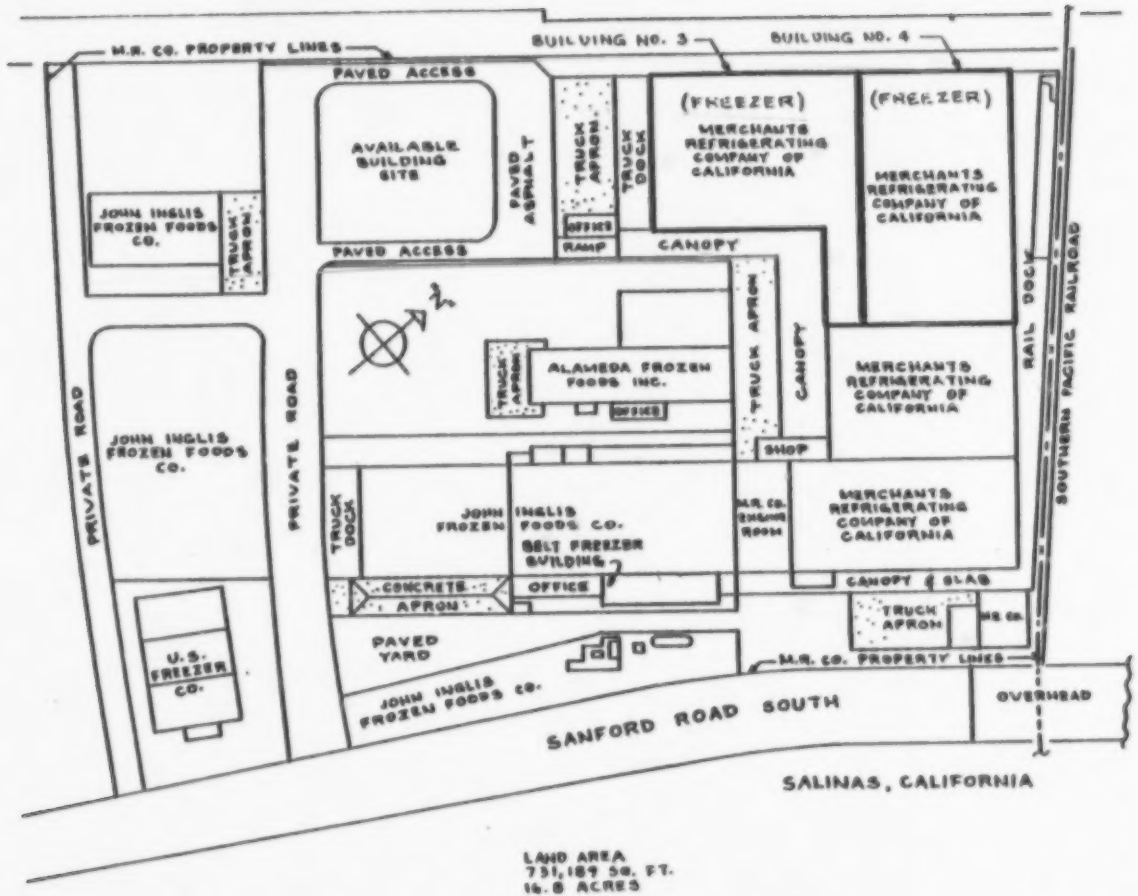
At Salinas, one-half of the food pro-

cessed is by the belt method and placed in tote bins or 50-pound cartons (mostly in tote bins). The other half is packaged in 10 ounce cartons. John Inglis Frozen Food Company is the major processor at this facility.

No portion of the freezing room space is specifically rented to a particular tenant or processor. Charges for storage are paid on a weight per month basis.

The following constitutes schematic drawings of the petitioner's facilities:


SPENKER AVENUE
AVAILABLE BUILDING SITES
POULTRY FOODS, INC.
DIVISION OF BEATRICE FOODS
M.R. CO. ACCESS ROAD
TENAYA DRIVE
BUILDING "F"
ADDITION
(FREEZER)
M.R. CO. BLDG. "D"
M.R. CO. BLDG. "B"
M.R. CO. BLDG. "C"
M.R. CO. BLDG. "E"
M.R. CO. BLDG. "F"
M.R. CO. BLDG. "A"
M.R. CO.
JIFFCO
YOSEMITE BOULEVARD
LAPHAM DRIVE
DALY AVENUE
TENAYA DRIVE
"N"
CAMPBELL SOUP COMPANY
RICH OF CALIFORNIA
LAND AREA
1,674,713 SQ. FT.
38.5 ACRES
MODESTO, CALIFORNIA



LAND AREA
731,189 SQ. FT.
16.8 ACRES

REASONS FOR GRANTING THE WRIT

This Court is urged to exercise its discretion in favor of granting the writ for the following reasons:

(1) to resolve a conflict between the Circuit Courts for the Ninth Circuit and Fourth Circuit relating to questions raisable on appeal and failing to follow its own precedent.

(2) to resolve an important question of a provision of the Internal Revenue Code since this case is the only decision dealing with an interpretation of the meaning of "bulk storage of fungible commodities" which term was first introduced into the Internal Revenue Code in 1971, and which term is of great importance to the storage and transportation industries in the United States.

I. The Lower Courts should have considered the entire applicable provisions of the Internal Revenue Code.

The lower courts were in error when they considered only the applicability of 26 U.S.C.A. §§ 48(a)(1)(B) (iii), although 26 U.S.C.A. §§ 48(a)(1)(A) was equally applicable to the facts before the court. In its complaint petitioner claimed that these facilities met the requirements of 26 U.S.C.A. §§ 48. Relief should have been granted to petitioner if the facts of the case met the requirements of any subsection of 26 U.S.C.A. §§ 48. Refusal to do so was error.

II. The Lower Courts refused to consider a provision of the Internal Revenue Code although pleaded.

The Court of Appeals refused to consider whether the facilities were

really "giant refrigerators" and thus entitled to the investment credit under 26 U.S.C.A. § 48 (a)(1)(A) because that point allegedly was not raised in the lower court. The memorandum opinion of the lower court (C-25) states that two cases relied upon by the petitioner are Catron v. Commissioner, 50 T.C. 306 (1968) and Central Citrus Co. v. Commissioner, 58 T.C. 365 (1972). In Catron where freezer facilities similar to those here involved the Court stated in footnote 5:

> "In reality what we are dealing with here is a 40 foot square walk-in cold storage refrigerator attached to the end of an adjoining structure."

The Tax Court went on at footnote 7:

> "The cold storage room is basically a giant refrigerator and may arguably qualify apart from its storage functions, under the regulatory exceptions for structures which are essentially items of equipment. See Sec. 1-48-(1)(e) (1) Income Tax Regs.

> We deem it unnecessary to pursue this possibility in light of our conclusion that the room constitutes a storage facility."

Inasmuch as the petitioner relied upon Catron in the lower court and the lower court considered that case, every point favorable to the petitioner in that case must be deemed to have been raised in the lower court.

III. The Circuit Court refused to follow its own precedents.

The Court of Appeals refused to consider 26 U.S.C.A. §§ 48(a)(1)(A) on the ground that it was raised for the first time on appeal. This holding was in direct conflict with its own decision in Ah Pah Redwood v. Commissioner, 251 F. 2d 163 (9th Cir., 1957). In that case its decision was based on a section of the Internal Revenue Code not raised by either party in the lower court. In the instant case not only was the subsection

of the Internal Revenue Code raised by the pleadings, but the facts necessary to bring such subsection into play were before the lower court.

In the last paragraph of the Court of Appeals' opinion, (A-7) the Court states: "This contention was not made in the district court, and we will not consider it for the first time on appeal." The Court cites for its authority United States v. Patrin, 575 F. 2d 708, 712 (9th Cir., 1978), and Redwood Empire Savings and Loan Assn. v. Commissioner, 628 F. 2d 516, 521 (9th Cir., 1980). Based upon an analysis of the foregoing two cases, it is difficult to understand how the Court reached its determination. As heretofore pointed out, in the instant case all the necessary facts were before the lower court. In United States v Patrin, supra at page 712, the Court notes that this

Circuit has recognized an exception to the general rule. "When the issue conceded or neglected in the trial court is purely one of law and either does not affect or rely upon the factual record developed by the parties . . . the Court of Appeals may consent to consider it. The evident principal underlining this exception is that the parties against whom the issue is raised must not be prejudiced by it." Since the "giant refrigerator" theory is an alternative legal principal based upon the same facts that were before the lower court, in no way could the United States be prejudiced by its presentation to this Court. In fact, the United States had every opportunity in its answering brief to the Court of Appeals to show that as a matter of law, the "giant refrigerator" theory was not applicable to the instant case.

Since a pure question of law is involved and no prejudice is shown herein, this Court should have considered this particular point of law on appeal, particularly in view of the fact that it was pleaded in the complaint.

In Redwood Empire Savings and Loan Assn. v Commissioner, supra, the Court notes at page 521 that in the lower court, the plaintiff taxpayer did not develop the factual basis to establish the deduction which was raised on appeal for the first time. This, of course, is not applicable to the present case since all necessary facts were before the Court.

IV. The Circuit Court is in conflict with the Fourth Circuit.

The Court of Appeals in the instant case is in conflict with the decision of the United States Court of Appeals for the Fourth Circuit in Cooper

v. Commissioner of Internal Revenue, 197 F. 2d 951 (1952). In that case the Court reversed the Tax Court because it refused to apply certain sections of the Internal Revenue Code which applied to the facts even though such provisions were not pleaded. In the instant case, although such provision was pleaded, the Ninth Circuit refused to consider it.

The effect of the refusal of the Circuit Court to consider a subsection of the Internal Revenue Code to which the pleadings and established facts applied was to wrongfully deprive the petitioner of a tax credit to which it was entitled and thereby unjustly enriched the United States.

V. The Lower Courts erred in its definition of "fungible goods".

The lower court held that the

retention of control and identification of goods which were fungible destroyed the fungibility of such goods for purposes of 26 U.S.C.A. 38.

There is no definition in the Internal Revenue Code for the term "fungible commodities".

However, the Senate Committee Report (92d Cong. 1st Sess. Rep. No.92-437 (1971) 26) states: "The commodity stored must be fungible in nature; that is, of such a nature that one part may be used in place of another". Congress meant that if a commodity is of such a nature that one part may be used in place of another, then it is fungible. Nothing more is required. The lower court found that the commodities stored herein were of such a nature that one part could be used in place of another.

However, the lower court added another requirement; i.e., the owner,

packer or distributor must not expect return of the particular items deposited, but rather an equal quantity of a similar product. This was an unwarranted modification of the congressional definition.

It should be further noted that the Commissioner's Regulations do not contain a disqualification of fungibility based upon retention of control or identification.

On pages C-7 amd C-8 of the Appendix, the lower court stated:

> "A particular lot may consist of several thousand tote bins. When the food processor later decides to package some of the commodities, it will requisition a certain number of bins. Merchants selects those bins closest to the aisle where they are stacked and delivers them to the processor or its assignee. Thus within any given lot, any bins may be delivered to the person requisitioning less than the entire lot. In addition, tote bins containing the same commodity may be stored under several lot numbers. At times,

> the processor will requisition all the lots containing the same commodity and upon their delivery to the rewrap shed, will commingle the contents prior to placing the food in small packages."

VI. Retention of control does not destroy fungibility.

The lower court in its memorandum decision stated the following:

> "The food placed in Merchants' facilities is identified by owner, packer or distributor. Although these commodities are fungible within each lot, and on occasion with other lots, they are nevertheless segregated according to the stated ownership at the time they are received, and each tenant retains control over his own product.
>
> The court is of the opinion that this identification by the tenant indicates an intent that the goods not be considered fungible." (C-50).

The lower court obviously ignored the facts before it. At the Modesto facility, there was only one processor and tenant. Therefore the question of segregation and control did

not apply.

VII. The Circuit Court should not have applied the "clearly erroneous" rule.

The Circuit Court in reviewing the decision of the lower court invoked the "clearly erroneous" rule. From a reading of Rule 52(a) of the Fed. Rules Civ. Proc. 28 U.S.C.A., and of the cases cited by the Circuit Court in its opinion, it was error by the Circuit Court to invoke the "clearly erroneous" rule in the review of this case. By so doing, the Circuit Court imposed an unjust burden upon the petitioner.

In the first instance, the entire sentence of Rule 52(a) should be considered and not the portion extracted by the Circuit Court. The sentence reads as follows: "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given

to the opportunity of the trial court to judge the credibility of the witnesses." Therefore, it is perfectly clear from reading the entire sentence that the "clearly erroneous" rule applies only to questions of fact and not to those of law. The question of fungibility is only one of law. An examination of the decisions in the lower court and Circuit Court indicates that the lower court was not called upon to make any findings of fact in this case since all facts were either stipulated to or contained in uncontroverted affidavits.

An examination of the other authorities cited by the Circuit Court also demonstrated an improper application of the rule. In Parkside, Inc. v. Commissioner, 571 F. 2d 1092 (9th Cir., 1977), the lower court was confronted by a variety of questions of fact. In the concurring opinion by Judge Pregerson,

on page 1098, he stated as follows:

> "Whether the taxpayer's real property was 'held primarily for sale' is a question of law ... to which the 'clearly erroneous' rule should be inapplicable."

In Commissioner v. Duberstein, 363 U.S. 278 (1960), the lower court was confronted with a question of fact as to whether the transfer of an automobile constituted a gift or was made for some other reason.

In Thompson v. Commissioner, 631 F. 2d 642 (9th Cir., 1980), the transactions before the lower court were ones of both mixed fact and law and therefore in the opinion of the Court was subject to the "clearly erroneous" standards of review, the rational being that the presence of the question of fact even though mixed with the question of law invokes the "clearly erroneous" rule. In the instant case, however, there were

no controverted questions of fact before the lower court.

In United States v. United States Gypsum Co., 333 U.S. 364 (1947), the Supreme Court stated at page 395 that "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with a definite and firm conviction that a mistake has been committed". It is obvious that from this Supreme Court decision that the use of the word "evidence" indicates that there are facts in controversy since evidence has to do with determination of questions of fact and not of law. Allen v. United States, 541 F. 2d 786 (9th Cir., 1976) follows the United States v. United States Gypsum Co. case heretofore referred to, and the "clearly erroneous" doctrine should not have been

invoked by the Circuit Court.

VIII. The Circuit Court should have reversed after finding error.

The Circuit Court in its opinion after improperly applying the "clearly erroneous" rule states: "We are not convinced that an error of this magnitude has occurred". (A-6)

Therefore, the Circuit Court admits that there was an error committed in the lower court. However, since the only error that the lower court could have committed was one of law, then the finding that there was error should have resulted in a reversal.

CONCLUSION

For all of the above reasons, it is respectfully prayed that the Writ of Certiorari be granted.

Respectfully submitted,

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(914) 428-2880

Appendix

APPENDIX A

UNITED STATES COURT OF APPEALS,
NINTH CIRCUIT

- x

MERCHANTS REFRIGERATING COMPANY
OF CALIFORNIA,

Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee.

- x

No. 79-4378

Argued and Submitted May 14, 1981.

Decided October 13, 1981.

Appeal from the United States District Court for the Eastern District of California.

Before MERRILL and CHOY, Circuit Judges, and HAUK,* District Judge.

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* The Honorable A. Andrew Hauk, Chief United States District Judge for the Central District of California, sitting by designation.

PER CURIAM:

Appellant Merchants Refrigerating Company of California (Merchants) provides cold storage facilities for food processors. Between 1973 and 1974. Merchants constructed large frozen food storage and shipping structures at Salinas and Modesto, California. Merchants contends these facilities are used "for the bulk storage of fungible commodities" under Int. Rev. Code § 48(a)(1)(B)(iii) which qualifies it for an investment tax credit under Int. Rev. Code § 38. Merchants' claims for tax refund were not approved, and it commenced this action. The district court entered summary judgment against Merchants on the question of whether the facilities fell under § 48(a)(1)(B)(iii). We affirm.

The following stipulated facts were submitted to the district court: The Modesto facility consists of 23,162 square

feet of freezer space and 7, 238 square feet of loading dock area added to an existing building. In Salinas, two adjoining buildings were constructed. The first contains 39,427 square feet of freezer space and 18,541 square feet used for an office and loading dock. The second holds 41,787 square feet of freezer space and 10,055 square feet of loading dock area.

No processing takes place in these structures. Food processors deliver frozen fruits, vegetables and fish to Merchants packed in 64-cubic-foot tote bins, 50-pound boxes and cases of 10-ounce packages. The containers are marked with a description of the product, a warehouse lot number and the name of the owner, packer or distributor before storage. Each processor retains control over its products while stored and is charged on the basis of quantity.

New property eligible for section 38 investment tax credit includes:

(A) tangible personal property, or

(B) other tangible property (not including a building and its structural components) but only if such property --

(i) is used as an integral part of manufacturing, production or extraction ... or

(iii) constitutes a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities ...

26 U.S.C. § 48(a)(1)(emphasis added). In the district court, Merchants argued that the cold storage facilities fell under this definition because food held in tote bins and 50-pound boxes before final processing is in "bulk storage" and the in-

terchangeability of containers within a particular lot made the goods fungible.

The parties were unable to cite any cases interpreting this provision. Instead, their arguments relied on legislative history, tax regulations, revenue rulings, federal warehouse law, the Uniform Commercial Code, tax court interpretations of the superseded portion of section 48 and Webster's Dictionary. In a carefully reasoned memorandum, the district court weighed each party's agruments before deciding that the food stored by Merchants was not fungible since containers were identified by owner, packer or distributor and processors expected return of the particular items deposited rather than an equal quantity of a smiilar product.

Where the district court rules on questions involving a mixture of fact and law, reversal is not warranted unless the

finding was "clearly erroneous." Parkside, Inc. v. Commissioner, 571 F.2d 1092, 1095-96 (9th Cir. 1977)(per Choy, Circuit Judge, with special concurrence). See also Fed.R.Civ.P. 52(a); Commissioner v. Duberstein, 363 U.S. 278, 291, 80 S.Ct. 1190, 1200, 4 L.Ed.2d 1218 (1960); Thompson v. Commissioner, 631 F.2d 642, 646 (9th Cir. 1980), cert. denied,-U.S.--101 S.Ct. 3110, 69 L.Ed.2d 972 (1981). "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." United States v. United States Gypsum Co., 333 U.S. 364, 395, 68 S.Ct. 525, 542, 92 L.Ed. 746 (1948); Allen v. United States, 541 F.2d 786, 788 (9th Cir. (1976) We are not convinced that an error of this magnitude has occurred.

Merchants has also advanced the argu-

ment that the cold storage rooms were "giant refrigerators" eligible under Int. Rev. Code §§ 48(a)(1)(A) for investment tax credits. This contention was not made in the district court, and we will not consider it for the first time on appeal. United States v. Patrin, 575 F2d 708, 712 (9th Cir. 1978); accord, Redwood Empire Savings and Loan Assn. v. Commissioner, 628 F.2d 516, 521 (9th Cir. 1980).

The judgment of the district court is AFFIRMED.

APPENDIX B

Filed November 25, 1981

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

- - - - - - - - - - - - - - - - - - - -x

MERCHANTS REFRIGERATING COMPANY OF CALIFORNIA,

Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee.

No. 79-4378

ORDER

- x

Before: MERRILL and CHOY, Circuit Judges, and HAUK,*, District Judge.

The panel as constituted in the above case has voted to deny the petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc and no judge of the court has voted to grant re-

* The Honorable A. Andrew Hauk, Chief United States District Judge for the Central District of California, sitting by designation.

hearing en banc. F.R.App.P. 35(b).

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

APPENDIX C

IN THE UNITED STATES DISTRICT COURT

FOR THE EASTERN DISTRICT OF CALIFORNIA

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MERCHANTS REFRIGERATING
COMPANY OF CALIFORNIA,

Plaintiff, CIVIL NO.
S-77-454

vs.

UNITED STATES OF AMERICA,

Defendant.

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MEMORANDUM

This case is before the court on the parties' cross-motions for summary judgment. Plaintiff seeks district court review of the Internal Revenue Service denial of its claims for tax refunds of certain taxes paid for fiscal years ending March 31, 1973, and March 31, 1974. Jurisdiction is alleged under 28 U.S.C. § 1348(a)(1).

Merchants Refrigerating Company of California (Merchants) is a wholly-owned

subsidiary of Merchants Refrigerating Company, a New York corporation. Plaintiff provides cold storage facilities for food processors. Merchants' principal place of business is located in Modesto, California. Other facilities are owned in Salinas and Santa Clara, California.

During the 1973 fiscal year, plaintiff constructed a refrigerated storage facility at its Modesto location. Similar structures were built by plaintiff at its Salinas location in fiscal years 1973 and 1974. Plaintiff alleges these three facilities qualify for the tax investment credit provided for in section 38 of the Internal Revenue Code, 26 U.S.C. §§ 38. Based on its contention that these structures are "section 38 property" and therefore entitled to the investment credit, plaintiff timely filed claims for refund. In addition, Merchants

seeks a revision in the amount of depreciation allowed for the 1973 and 1974 fiscal years contending that the facilities should be eligible for 200 percent declining balance depreciation pursuant to section 1245 of the Internal Revenue Code, 26 U.S.C. § 1245, rather than the 150 percent straight line depreciation allowed if the property is characterized as section 1250 property, 26 U.S.C. § 1250. Timely claims for refunds of these amounts were also filed. Finally, plaintiff seeks an increase in its franchise tax deduction for 1974. At the time this complaint was filed, however, plaintiff had not yet sought a refund for the franchise tax as required by 26 U.S.C. § 7422.

The parties have filed cross-motions for summary judgment on several grounds. The Government contends that the court lacks subject matter jurisdiction over the

franchise tax claim because of the failure to seek a refund. To cure the jurisdictional defect, plaintiff has responded with a motion to supplement its complaint to allege it had subsequently sought a refund for this amount which was denied by the IRS. As a second ground for summary judgment, the parties seek a ruling as to whether or not the three storage facilities are section 38 property. Finally, the parties have stipulated that the applicable rate of depreciation will be determined by the outcome of the tax investment credit issue. This court will first consider whether the facilities qualify as section 38 property.

NATURE OF THE COLD STORAGE FACILITIES

The Modesto facility, constructed in 1973, is known as the "addition to Building F" and consists of three separate areas. The main part of the

structure is a fully enclosed freezer room. Also part of the addition are a truck dock and rail dock, both of which are enclosed.

The Salinas facility known as "Building 3" was constructed in 1973 and consists of a large freezer area, a warehouse office and a canopy-covered truck dock. In 1974, Merchants constructed another cold storage facility in Salinas, "Building 4", which consists of an enclosed freezer area and a canopy-covered truck dock. The parties have stipulated that each of the three buildings at issue is depreciable property which had, at the time it was placed in service, a useful life in excess of four years.

Each of these structures is used to store frozen perishable commodities but is not used by Merchants for any food processing activities. In Modesto, the

foods stored include such vegetables as lima beans, spinach, broccoli, green beans, mixed vegetables, peas, carrots, and asparagus. In addition to vegetables fruits such as boysenberries have been stored there. At Salinas, not only are fruits and vegetables stored, but also frozen fish such as salmon and herring.

Processors use three methods to prepare food for storage in Merchants' facilities. In each operation, the product is initially received by the processor in its raw state. It is cleaned, graded, processed and then frozen. Under the first method of preparation, known as belt freezing, the unfrozen product is poured from the processing line onto a mesh belt. As it is conveyed along this belt, extremely cold air is forced up from underneath the food causing it to float on top of the belt while simultaneously freezing it

individually. Thus, peas treated in this manner would be separately frozen and loose flowing as they reach the end of the belt. From there, the food is poured into a tote bin or other large container such as a 50-pound carton. Tote bins are 4' x 4' x 4' in size and are lined with overlapping polyethylene plastic bags. After being stamped or tagged with a description of the product, its grade, warehouse lot number and the name of the packer, owner, or distributor, the tote bins are removed from the processor's premises by forklift trucks and delivered to Merchants' freezer room.

A particular lot may consist of several thousand tote bins. When the food processor later decides to package some of the commodities, it will requisition a certain number of bins. Merchants selects those bins closest to the aisle where they are stacked and delivers them to the

processor or its assignee. Thus, within any given lot, any bins may be delivered to the person requisitioning less than the entire lot. In addition, tote bins containing the same commodity may be stored under several lot numbers. At times, the processor will requisition all the lots containing the same commodity and, upon their delivery to the rewrap shed, will commingle the contents prior to placing the food in small packages.

Some processors are not equipped to handle tote bins but can use the 50 pound containers. In such instances, these containers will be sent to the processor when it is ready to package the commodities in small cartons. These containers may also be sent directly to customers without further packaging where such buyers have no need to purchase the food in small packages.

Not all commodities are amenable to

belt freezing. Vegetables such as spinach, broccoli and celery, for example, cannot be frozen separately but must be packaged and then frozen in one solid mass within the carton. For these foods, the processor will clean, grade, cut and package the commodities, usually in 10-oz. cartons, and then label them. The unfrozen packages are put on freezer racks which in turn are placed in a blast freezing tunnel. Air at minus 35 degrees is forced through the tunnel for three to four hours to freeze the packages. Thereafter, the commodities are taken to Merchants' freezer room where they are stored on pallets by lot number. From time to time, packages with one label may be needed to fill the needs of a different distributor; the processor will remove the labels and relabel them with the appropriate name.

The third method of freezing is called plate freezing. It is similar to blast

freezing in that the product is packaged in consumer-sized packages and labeled as soon as it comes off the processing line. The packages are placed on a refrigerated shelf where they remain until they are frozen. From there, they are placed in larger packing crates, taken to the freezing room, and stored by lot number and the name of the distributor, owner or packer.

Of the three methods used, approximately one-half of the food stored in all of Merchants' Salinas facilities is frozen by the belt method so that it is placed in tote bins or 50 pound cartons. The other one-half is packaged in 10 oz. cartons. At Modesto, almost all of the food is placed into tote bins after freezing. None of the processing and freezing takes place within the freezer room itself, although blast freezing is done in other sections of Merchants' buildings. The freezing room

space is not specifically rented or leased to any particular tenant or customer. Rather, each tenant pays on a weight-per-month basis. However, each tenant retains control over its own product, and the products cannot be commingled in any way by Merchants without the express permission of the owner.

TAX INVESTMENT CREDIT

Section 38 of the Internal Revenue Code provides for an income tax credit for investments in certain property. Property which qualifies for this credit is defined by section 48. Section 48 provides in part:

> (1) In general.- Except as provided in this subsection, the term "section 38 property" means --
>
> (A) tangible personal property, or
>
> (B) other tangible property (not including a building and its structural components) but only if such property-

(i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or.

(iii) constitutes a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state) . . .

26 U.S.C. § 48 (a)(1) (Emphasis added). This statute was amended to the above form in 1971. Pub. L. No. 92-178, § 104 (a), 85 Stat. 497. Prior to that time, section 38 property was defined as:

(A) tangible personal property, or

(B) other tangible property (not including a building and its structural components) but only

if such property --

(i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services, or

(ii) constitutes a research or storage facility used in connection with any of the activities referred to in clause (i) . . .

26 U.S.C. §§ 48(a)(1)(1962) (amended 1971) (Emphasis added).

A comparison between the two provisions demonstrates that, prior to 1971, any storage facility used in connection with the specified activities might qualify for the tax investment credit, whereas after 1971, only those facilities used for the purpose of "bulk storage of fungible

commodities" in connection with the designated activities are deemed eligible for section 38 treatment. That Congress intended to limit the class of storage facilities is clear from the legislative history of the Revenue Act of 1971. The House Conference Committee report states:

> The Senate amendment clarifies the provision of present law relating to storage facilities (section 48(a)(1)(ii) of the Code) so as to make it clear that such provision applies only to facilities for the bulk storage of fungible commodities, including commodities in a liquid or gaseous state.

H.R. Conf. Rep. No. 92-708, 92d Cong., 1st Sess. (1972), reprinted in 1972 U.S. Code Cong. & Ad. News 2053, 2056. Similarly, the Senate Report states:

> Since the Internal Revenue Service has encountered significant difficulties interpreting this provision (section

> 48 of the Code), the committee believes it is desirable to clarify the law regarding the types of storage facilities, . . which are entitled to the credit.

S. Rep. No. 92-437, 92d Cong., 1st Sess. (1972), reprinted in 1972 U.S. Code Cong. & Ad. News 1918, 1936.

Defendant stated at oral argument that Merchants' Modesto and Salinas facilities built in 1973 and 1974 meet all the requirements of section 38 property except that they do not house fungible goods in bulk. The gravamen of the Government's argument is that these facilities do not hold fungible commodities in bulk because the foods are of several varieties which are already processed, graded, containerized or packaged, and often labeled. Merchants asserts that, as to the tote bins and 50-pound cartons, the foods are fungible because any bin or carton within

a particular lot (and sometimes several lots) is interchangeable with any other prior to final packaging. Merchants further contends that the food is held in bulk because it has not been packaged in its final form, particularly when held in the tote bins and 50-lb. cartons. Finally plaintiff says that even the 10-ounce packages are fungible because a label can be removed if the processor wishes to use particular packages for a different buyer than the one for whom the food was originally labeled.

There appear to be no cases dealing with storage facilities built after 1971 in which the court has had to interpret the meaning of bulk storage of fungible commodities. The parties have therefore relied on legislative history, tax regulations and revenue rulings, tax court decisions as to pre-1971 facilities, the Uniform Commercial Code and Webster's

Dictionary.

Turning first to legislative history, the Government quotes from the Senate Committee Report which defined "bulk" and "fungible" as follows:

> Bulk storage has reference to the keeping of a commodity in a large mass prior to its consumption or utilization. The commodity stored must be fungible in nature, that is, of such a nature that one part may be used in place of another.

S. Rep. No. 92-437, supra. While the Treasury Regulations do not define "fungible", they have adopted the above language almost verbatim to describe the meaning of "bulk" storage. See 26 C.P.R. §§ 1.48-1(d)(5)(ii). To illustrate the meaning of bulk storage, the regulations give the following example:

> In the case of property described in section 50, property will constitute a

> storage facility only if the facility is used principally for the bulk storage of fungible commodities. Bulk storage means the storage of a commodity in a large mass prior to its consumption or utilization. Thus, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage.

Id. The Uniform Commercial Code states that: "fungible" means goods or securities of which any unit is, by nature or usuage of trade, the equivalent of any other like unit. Goods which are not fungible shall be deemed fungible for the purpose of this Act to the extent that under a particular agreement or document unlike units are treated as equivalents.

U.C.C. § 1-201. Webster's New Collegiate Dictionary (1976 ed.) defines "bulk" in part as "a ponderous shapeless mass of

material". "Fungible" is defined as "of such a kind or nature that one specimen or part may be used in place of another specimen .. interchangeable".

On the basis of these definitions, the Government asserts that Merchants' facilities do not house fungible goods nor do they store commodities in bulk. The defendant argues that the foods are not fungible because they consist of many varieties, grades and sizes and because they have been processed. Additionally, the Government contends that even the same type of food may not be fungible as to separate lots since there may be variations in quality and size. To support its "bulk" argument, the defendant points out that the foods have been sorted and packaged in units so that the items no longer are held in a large mass. According to the Government, this is true whether the items are placed in tote bins

or in 10-ounce packages.

Merchants, on the other hand, believes the fungibility requirement is met as to the tote bins because the foods are fungible within each lot. Thus, although there may be as many as 2000 bins within a lot, each bin is interchangeable with any other in that lot. Plaintiff further contends that the packaged foods are also interchangeable because, if a processor seeks to fill a Birds Eye order but does not have enough labeled packages, it can take packages containing the same commodities wrapped with Snow Crop labels, remove the labels, and rewrap the package with Birds Eye labels. Merchants, however, has not addressed the question as to whether or not the 10-oz. packages meet the bulk requirement of section 38.

The parties also refer to other relevant Treasury Regulations in effect after 1971 which give some indication of the

type of structure which may qualify for the tax credit. Thus, warehouses are not entitled to section 38 treatment because they are buildings. § 1.48-1(e)(1). Storage facilities include oil and gas storage tanks and grain storage bins. § 1.48-1(d)(5)(i). "Buildings" does not include the latter two structures, silos, or fractionating towers. § 1.48-1(e)(1). Although a storage facility must be used in connection with specific activities, the taxpayer-owner of such structures need not be engaged in the activity. § 1.48-1(d)(5)(i).

The Government has consistently argued that the 1971 amendment to the definition of section 38 property indicates an intent by Congress to limit investment credit to structures which are essentially containers themselves - structures such as grain storage bins, silos and gas storage tanks - rather than ware-

house-type facilities which are used to store a wide variety of products. At oral argument, however, counsel for the defendant suggested that a facility storing a variety of commodities might qualify if the different items were stored seriatim rather than at the same time as frequently occurs in the plaintiff's structures. Merchants points out that the examples of storage facilities set forth in the regulations "include oil and gas storage tanks and grain storage bins", but asserts that such examples are clearly not intended to be exclusive.

Both parties rely on several tax court rulings which, even though each dealt with structures built prior to 1971, shed some light on this issue. Merchants was the plaintiff in an earlier action before the Tax Court seeking a determination that its 1968 storage facility qualified for section 38 investment credit. In Merchants

Refrigerating Co. of California v. Commissioner, 60 T.C. 856 (1973), the freezer room to which the Modesto "addition F" was added in 1973 was held to be a storage facility within the meaning of section 38. The characterization of that facility as section 38 property, however, is not controlling in the instant case. The Tax Court made it clear that its ruling was based upon the statute as it was worded prior to 1971. After citing the 1968 definition of section 38 property as set out in section 48, it noted that those provisions were amended by the Revenue Act of 1971 which "replaced the term 'storage facility' in sec. 28(a)(1)(B) with the narrower concept of "a facility used . . . for the bulk storage of fungible commodities". Id. at 859 n.1. Yet, the court believed it was bound by two prior tax court decisions "not fairly distinguishable from the present case",

not only because of stare decisis principles, but

> particularly since the statutory provisions involved remain applicable only up to the time when the 1971 amendments to the statute take over (see fn.1 supra).

Id. at 860. The court continued:

> nor do we accept the Government's argument that the freezer room is not in any event a "storage facility" within (B)(ii) on the ground that "the structure must be used for the bulk storage of fungible goods". Passing the question whether the frozen foods stored in petitioner's facility may be regarded as "fungible", the requirement of fungibility appeared for the first time in the 1971 amendments to the statute (fn.1 supra) which were not retroactive to the

year before us.

Id. Thus, the Tax Court recognized that only certain storage facilities would be eligible for tax investment credit after 1971. Significantly, the court also stated under facts very similar to those before this court that the merchandise stored in Building F was generally fungible within each particular lot but not fungible as between lots. Id. at 858. This latter statement, however, does not address the broader question as to whether commodities must be fungible as to every other item within the facility, or whether it is sufficient if they are fungible within a particular lot.

The two cases relied upon by Merchants are illustrative of the approach taken by the courts in dealing with pre-1971 structures. In Catron v. Commissioner, 50 T.C. 306 (1968), an apple farmer sorted graded and boxed apples after which he

placed them in a cold storage facility to await sale and shipment. The court said that the facility was used solely to store goods used in food processing so that it qualified for section 38 treatment. In Central Citrus Co. v. Commissioner, 58 T.C. 365 (1972), the facility at issue consisted of a room where oranges were placed prior to or after packaging to condition the fruit. The court determined that the room was eligible for the investment credit since it was an integral part of processing. Thus, as to structures built before 1971, the courts applied the law very broadly to include any storage facility at any stage of processing whether or not the commodities were in mass or sorted and boxed.In a footnote, however, Merchants indicated that Catron might have been decided differently under current law. The court found indications

in the regulations

> that facilities used to store boxed fruit might be treated differently under the 1971 legislation from the manner in which such facilities were treated, under prior law, in Catron.

Merchants Refrigerating Co. of California v. Commissioner, supra at 860 n.3, citing Treas. Reg. §§ 1.48-1(d)(5)(ii).

As final support for its position, the Government relies on three post-1971 Revenue Rulings. As an initial matter, this court rejects plaintiff's contention that such rulings are "only opinions of an employee" of the Interal Revenue Service and thus of no persuasive value. Although the Internal Revenue Service cautions that its rulings should be applied and followed only when the facts are closely similar, courts have held them to be entitled to some weight. See Groves v. U.S., 533 F.2d 1376 (5th Cir.

1976).

The Government first cites Revenue Ruling 74-451. The taxpayer in that case built a refrigeration facility in 1972 in to which varieties of apples were placed prior to packaging. After final sorting and packaging into boxes, most of the boxes were shipped out to customers but a few stayed in the facility for a short time. The Commission concluded that, even though a few boxes were placed in the storage room, the facility was used principally to hold the apples in bulk prior to final processing so that it qualified for section 38 treatment under the amended statute. Although the Government contends that these apples were placed in the storage bins without any prior sorting, grading, or processing, it is not clear from the opinion if, in fact, none of these activities had taken place prior to the time the apples were placed in the

facility. Since the ruling says the apples were removed from the facility for final sorting, there is a suggestion that some pre-sorting may have taken place so that the bins of apples may not have been completely interchangeable.

The defendant also cites Revenue Ruling 74-452 which involved two different situations. In the first, a 1972 structure was leased to a wholly-owned subsidiary for use in its food processing business. The subsidiary purchased fruit from growers and put the fruit into cans or drums. It then placed these containers into the structure for which it sought a tax credit. The taxpayer also subleased storage space to others for storing poultry, vegetables and fruits. Unfortunately, the opinion does not say whether these latter goods were processed, sorted, packaged, or placed into tote bins. In the second situation two 1972 structures were

used to store processed food products for redistribution. Most of the space was leased to food processors. Again, the ruling does not give many important details. In both instances, the Internal Revenue Service ruled that the structures were not section 38 property since none of them was used principally for the bulk storage of fungible commodities.

The Government argues that the facts of the second situation in Revenue Ruling 74-452 are virtually identical to those of the instant case. Since few details are set forth in that ruling, however, it is impossible to tell if the Commissioner denied the tax credit because the foods had been placed in packages and were therefore not held in bulk or because the foods had been processed, and, impliedly, sorted and graded so that they may have been considered to be not fungible. Revenue Ruling 74-452 does not, therefore,

compel the conclusion that Merchants' facilities fail to qualify for the investment credit because they are used to store processed foods of several varieties which have been sorted, graded and quite often packaged.

The Government's arguments can be placed into three categories: (1) the goods are not fungible because they consist of different varieties; (2) they are not fungible because they have been sorted, graded and processed; and (3) they are not fungible or held in bulk because they have been containerized and identified as to owner. Because section 38 requirements are met only if commodities stored therein are both fungible and held in bulk, Merchants' facilities will fail to qualify if any one of the Government's three assertions is correct. The court will therefore examine each argument individually.

As to the Government's first point, the fact that Merchants stores an assortment of vegetables, fruits and fish concurrently does not, by itself, compel the conclusion that the storage facilities do not house fungible commodities. One need only examine the characteristics of grain storage to note that facilities may still qualify for the tax credit even though more than one kind of commodity is stored in separate bins at the same time. Since the Government, throughout its argument, has relied on grain storage bins as an example of section 38 property and, because the Treasury Regulations did not delete this type of facility as indicative of such property even after the statute was amended in 1971, it is appropriate to compare the nature of Merchants' goods with those placed in grain bins.

Although the Government implied that grain storage bins house a single

commodity, counsel for both parties admitted at oral argument they are not familiar with the details of grain storage activities. Subsequent research by this court reveals that it is common for grain storage facilities to house a variety of grains at any given moment during the year. In F.P. Wood & Son v. United States 314 F. Supp. 1205 (E.D.N.C. 1970), the court stated:

> In the grain business, a large number of bins is necessary, because several varieties of grain are handled and each type must be binned separately. Each grain has five different grades which must be binned separately also. The problem is further complicated since dried grain must be binned separately from undried grain. (Emphasis added).

Id. at 1207. The court noted that the taxpayer, Wood, dealt in several varieties

of grain including corn, soybeans and cereal grains, including wheat, oats, barley and rye. When brought to Wood's storage facility, the grain was weighed, graded and dumped into the appropriate storage bins. Id. at 1206. The court concluded that the concrete grain storage facility at issue was section 38 property, and, although the structure in which the numerous bins were located was built in 1966, there is nothing in the amended statute, subsequent Treasury Regulations, tax court opinions, or Revenue Rulings which suggests that a different result would be reached had the Wood facility been built after 1971. The facts set forth in Sherley-Anderson-Rhea Elevator, Inc. v. U.S., 315 F. Supp. 1055 (N.D. Tex. 1970), and C.I.R. v. Schuyler Grain Co., 411 F.2d 649 (7th Cir. 1969), also indicates that a grain facility will typically house more than one type of commodity.

Indeed, the very term "grain" is defined by the Department of Agriculture to include products such as wheat, corn, oats, barley, rye, flaxseed, rice, sunflower seeds, field peas, soybeans, emmer, sorghum, safflower seed, triticale, millet and such other products as are ordinarily stored in grain warehouses. 7 C.F.R. §§ 102.2(j). Of course, the fact that any one of these commodities may be classified as grain does not mean that more than one such item will be stored in a grainery. Nevertheless, the cases cited above indicate that this may indeed occur in the grain business.

On the other hand, for a grain storage facility to be analogous to Merchants' structures, more than one variety of goods must be stored concurrently. It is not clear in Schuyler if that is indeed the case or if the four varieties stored therein arrive at various seasons during

the course of the year. While this latter sequence occurs at the Merchants' facilities to some degree, plaintiff admitted that, at most times, the facilities contain a large variety of foods. In Wood, the language quoted above clearly indicates that the plaintiff in that case maintained different bins because it had to store several varieties of grains at the same time. In Sherley, much of the grain arrived at different times of the year, but, because some grain was stored as much as a year, it follows that at some point the facility contained more than one variety of grain. 315 F. Supp. at 1057.

The court recognizes, as it stated at oral argument, that a single grain bin or silo will contain only one kind of grain so that the entire interior of that particular structure is devoted to the storage of a single commodity. Neverthe-

less, there is nothing in the statute or Treasury Regulations to indicate that a storage facility which contained several bulk bins or hoppers located side by side and housed under one roof would not qualify under section 38 if the contents of each bin differed from that of any other at a given moment. Such facilities would not be unlike Merchants' freezer rooms insofar as they house tote bins side by side, under one roof. Since the statute does not state that only storage bins of a certain size may qualify for section 38 treatment, the court is unwilling to conclude that the plaintiff's tote bins are not analogous to grain bins or hoppers located within one larger structure. And because grain storage facilities concurrently store a variety of grains, Merchants' facilities do not lose their section 38 eligibility simply because they house more than one variety

of food at the same time. Thus, the Government's first point is rejected.

The Government's next argument is that fungibility is not present in this case because the foods have been sorted, graded and processed. This argument, also, must be rejected. A very similar sequence of events occurs in preparing grains for storage in facilities the courts considered as meeting section 38 requirements prior to 1971. In Wood, for example, the following events took place:

> When grain is brought to Wood's storage facility, it is weighed and graded according to moisture content, test weight, amount of damage, and foreign material content. Then the grain is dumped into the appropriate storage bin. Frequently, various grades of a particular grain are blended to achieve a different grade. For example, No. 2 corn,

> the grade generally sold, has a permissible foreign material limit of 3%; by blending a bin of corn with a 5% foreign material content (No. 4 corn) with a bin of corn containing only 1% of foreign material (No. 1 corn); the result may reach a No. 2 corn. It is also possible to upgrade two bins of a particular grade of grain, depending upon particular grade factors.

The court continued:

> After the grain has been graded, it must be dried to reduce its moisture content. The actual drying process takes two or three hours, depending on the moisture reduction that is required. Drying is accomplished artificially by blowing hot air across the grain as it moves down the

dryer, and the process is necessary to prevent grain from spoiling and moulding. If the grain is not dried, it will be unfit for use in animal feed or food for human consumption. Wood's major grain, corn, has a moisture content of 20-25% at time of harvesting. The moisture must be reduced to 14-15% within 48 hours after the kernels have been removed from the cob to prevent spoilage.

Once the grain has been dried, it must be cooled and cleaned by screening out foreign matter and cracked grains. This process is particularly important if the grain is to be later sold to a processor who will use it in human food products.

Stored grain must also be aerated

> periodically and this is accomplished by use of large fans located under each bin .. After grain has been cleaned and dried, the bins are used for storage until the grain is sold.

314 F. Supp. at 1206-1207.

In the above example, the grain is first graded, and, unless blended, is segregated according to grade. To prevent spoilage, the grain is next dried by a process that takes two to three hours. When preparing some grains, such as corn, the kernels must be removed before the drying can commence. Once the grain is dried, it is cooled and cleaned. Even after the grain has been through these stages, it must still be aerated periodically.

The foods placed in Merchants' facilities go through similar stages before

they are sent to the freezer room for storage in tote bins. Depending upon the type of fruit, vegetable, or fish, the food will be sorted, cut, cleaned, occasionally blended (as with mixed vegetables), and frozen to prevent spoilage. At that point, it will be placed in bins until ready for final processing. The significant difference in the two types of pre-storage activities is the fact that, in the grain business, the preliminary activities are the first of many stages through which the grain may go and are conducted primarily for the optimimum efficiency in storing the products at this point. In the food freezing business, the food products may go through no other processing stages after storage except for final packaging. Thus, although grain may be sold as is for feed, it will frequently be ground for flour or converted to other products such as cooking

oils. On the other hand, the same step may take place as to Merchants' commodities where a food manufacturer such as Campbell Soup Company uses the bulk vegetables as ingredients for precooked items it markets. Thus, even this difference does not exist in every instance. As stated with reference to the Government's first argument, there is no indication that the 1971 amendment changed the type of grain storage bins which are now eligible for tax credits; accordingly, the court is of the opinion that it is appropriate to compare the processing, grading and sorting that occurs in the grain business with the similar events that take place in the frozen food industry, and to conclude that these activities do not make the frozen foods placed in Merchants' tote bins non-fungible goods. The Government's second argument must be rejected.

The Government's third point, however, has merit. The containerization and identification of the commodities by owners may result in the determination that they are no longer fungible goods held in bulk. As the court views the containerization and identification as two distinct issues, they will be discussed individually.

The Treasury Regulation quoted earlier indicates that commodities are no longer held in bulk once they have been boxed. See § 1.48-1(d)(5)(ii), supra at 9. Although this statement does not specify if the crossover point is reached, as Merchants contends, only after the goods are placed in the final package, or, as the Government argues, when they are put into any kind of container, including the tote bins, the court is of the opinion that the regulation refers to the final packaging. In this instance, that point

is reached when the food is placed into the 10-ounce packages. Merchants' comment that the labels may be exchanged goes to its fungibility argument but does not address the bulk requirement of section 38. Similarly, this point may also be reached when the food is put into the 50-pound containers since the containers may be sold directly to certain customers without further packaging. The court concludes that insofar as the storage facilities contain commodities that have been packaged in either 10-ounce or 50-pound containers, such storage is not bulk within the meaning of section 48 of the Internal Revenue Code defining section 38 property.

Turning to the tote bins, Merchants' contention that the goods stored in this manner are held in bulk is persuasive. These bins merely hold the food in a large mass until the processor is ready to put

the goods into the final package. The Government has cited no authority to support its suggestion that goods in 4' x 4' x 4' tote bins are not held in bulk but that grain placed in larger grain bins or silos is so held. Until the food is taken from these bins, therefore, it is held in bulk for purposes of section 38 treatment.

The second aspect of the Government's final point, however, creates an insurmontable bar for Merchants. Although defendant has not placed much emphasis on the fact that the goods in Merchants' facilities are identified as to the individual cwners who segregate their food and retain total control over its ultimate disposition, the court believes this issue is controlling. This identification and segregation has destroyed the fungibility of such goods.

Because there is no case law on point,

the court reaches this conclusion by analogy to federal warehouse law, federal regulations and cases that have attempted to define "fungible" in other contexts.

Under federal warehouse law, 7 U.S.C. §§ 241-273, owners of fungible goods are entitled to have their commodities kept separate in the absence of an agreement or custome to the contrary. 7 U.S.C. § 258. It is customary, however, to commingle fungible goods. 78 Am. Jur. 2d, Warehouses § 179. Under the Uniform Commercial Code, fungible goods so commingled are owned in common. U.C.C. § 7-207. Conversely, if the depositor has indicated that otherwise fungible goods must be identified and specially stored, the goods are not owned in common. Rather, the individual, upon demand, has the right to receive the very items he deposited with the warehouse. 7 U.S.C. § 258. See also 7 C.F.R. § 102.48.

These distinctions become important when it is necessary to determine the liability of warehousemen for the goods stored in their facilities. Thus, if fungible goods have been commingled and therefore owned in common, any loss can be replaced by the tender of goods of the same quality and quantity. If the owner intended that the goods be identified, they are not owned in common so that the loss of such goods is not satisfied by the tender of equivalent commodities. The word "fungible" in such cazes takes on specific legal significance.

Although case law is not prolific on this point, there are several courts that have concluded that otherwise fungible goods may loose their fungibility if identified and specially stored. In Edwards v. Cleveland Mill & Power Co., 138 S.E. 131, 53 A.L.R. 1404 (N.C. 1937), the court held that bales of cotton which

were weighed, numbered and marked so that they could be identified were not fungible goods, particularly where the contract of storage contemplated the return of the identical goods to the owners. Similarly, in Petzoldt v. Lawrence Warehouse Co., 157 F. Supp. 184 (D. Colo. 1957), the trial court concluded that the fact that the seed was bagged and tagged with the plaintiff's number, and intended to be kept separate from the other seed, indicated that neither party regarded it as fungible. On appeal, the Tenth Circuit affirmed on other grounds, First National Bank v. Petzoidt, 262 F.2d 540 (10th Cir. 1958), but held that the seed was fungible pursuant to a written agreement which expressly authorized the commingling of such goods.

The food placed in Merchants' facilities is identified by owner, packer, or distributor. Although these commodities are

fungible within each lot, and, on occasion, with other lots, they are nevertheless segregated according to the stated ownership at the time they are received and each tenant retains control over his own product. At oral argument, Merchants admitted it does not have the authority to commingle the products without the express authorization of the owner. There has been no evidence presented to the court that, in fact, the commodities are commingled. This is not, therefore, the typical bulk storage facility where the warehouseman has the ability to commingle fungible products such as grain or nuts unless the parties specify otherwise. Rather, each tenant expects that its goods will be identified, segregated and returned upon request. The court is of the opinion that this identification by the tenant indicates an intent that the goods not be considered fungible.

The court recognizes that the cases cited above construing the meaning of "fungible" have not done so in the context of tax investment credits. It may be argued that Congress intended the term to be defined in such a manner that wherever inherently fungible goods are stored in bulk, such facilities will come within the meaning of section 38 property even if the commodities are identified and held in bins according to individual ownership. Nevertheless, Congress has chosen terms that have certain legal connections. In the absence of any expressions of congressional intent to the contrary, the court feels constrained to apply the legal meaning given to the term "fungible" in contexts similar to the situation at hand. The court therefore concludes that the commodities stored in Merchants' facilities at issue here are not fungible within the meaning of section

48 of the Internal Revenue Code as it defines section 38 property. Accordingly, the defendant's motion for summary judgment on the grounds that plaintiff's Modesto and Salinas facilities built in 1973 and 1974 fail to qualify for the section 38 tax investment credit is granted. Plaintiff's cross-motion for summary judgment on this same issue is denied.

DEPRECIATION

As a second ground for summary judgment, the parties seek an adjudication as to the applicable rate of depreciation to be applied to the three buildings at issue here. The parties have stipulated that this court's ruling as to the eligibility of the facilities for tax investment credit under section 38 will be determinative of the depreciation question. Although the parties state that this property is limited to the 150 percent

straight line method of depreciation in the event it is not eligible for section 38 treatment, they have not briefed this issue. Since the parties may not stipulate to the law, Los Angeles Shipbuilding & Drydock Corp. v. United States, 289 F. 2d 222, 231 (9th Cir. 1961), the court declines to rule on the correctness of the parties' conclusion as to the applicable rate of depreciation in this instance. Should the parties wish such a ruling, they must renew their motions and support them by adequate briefing.

FRANCHISE TAX DEDUCTION

Plaintiff's motion to supplement its complaint to allege that it has filed a claim for refund as to franchise tax payments made for fiscal year 1974 is granted. Accordingly, the Government's motion for summary judgment on the grounds that the court lacks subject matter jurisdiction over the franchise

tax claim is moot.

IT IS SO ORDERED.

DATED: 3-2-79

T.J. MacBride
UNITED STATES DISTRICT
JUDGE

APPENDIX D

Filed April 19, 1979

IN THE UNITED STATES DISTRICT COURT

FOR THE EASTERN DISTRICT OF CALIFORNIA

- - - - - - - - - - - - - - - - - -

MERCHANTS REFRIGERATING COMPANY OF CALIFORNIA,

Plaintiff,

v.

UNITED STATES OF AMERICA,

Defendant

CIVIL NO. S-77 454 TJM

- - - - - - - - - - - - - - - - - -

O R D E R

Pursuant to this Court's Memorandum entered on March 2, 1979, and the Stipulation of the Parties,

IT IS HEREBY ORDERED that judgment be entered in favor of the defendant, United States of America, dismissing with prejudice Count I of the plaintiff's Complaint for Tax Refund as Supplemented.

IT IS FURTHER ORDERED that judgment be

entered in favor of the plaintiff, Merchants Refrigerating Company of California, in the amount of $5,956 plus interest as provided by law, on Count II of Plaintiff's Complaint for Tax Refund as Supplemented.

T.J. MacBride
UNITED STATES DISTRICT JUDGE

Opposition

Supreme Court, U.S.
FILED
APR 21 1982
ALEXANDER L. STEVAS
CLERK

No. 81-1533

In the Supreme Court of the United States

OCTOBER TERM, 1981

MERCHANTS REFRIGERATING COMPANY OF CALIFORNIA,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

Cases:	Page
Commissioner v. *Duberstein*, 363 U.S. 378	3
Cooper v. *Commissioner*, 197 F.2d 951	4
Parkside Inc. v. *Commissioner*, 571 F.2d 1092	3
Redwood Empire Savings & Loan Association v. Commissioner, 628 F.2d 516	4
Singleton v. Wulff, 428 U.S. 106	4
United States v. *Patrin*, 575 F.2d 708	4
Statutes, rules, and regulations:	
Internal Revenue Code of 1939 (26 U.S.C.) (1952 ed.):	
Section 117(e)	4
Section 117(f)	4
Section 23(g)(2)	4
Internal Revenue Code of 1954 (26 U.S.C.):	
Section 48(a)(1)(A)	2, 3
Section 48(a)(1)(B)(iii)	1
Rev. Rul. 74-452, 1974-2 Cum. Bull. 11	3
26 C.F.R. 1.48-1(d)(5)(ii)	3

In the Supreme Court of the United States

OCTOBER TERM, 1981

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MERCHANTS REFRIGERATING COMPANY OF CALIFORNIA, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner seeks review of the decision below in this federal income tax case holding that certain refrigerated food storage facilities that it placed in service during 1973 and 1974 were not used for the "bulk storage of fungible commodities," and therefore did not qualify for the investment tax credit under Section 48(a)(1)(B)(iii) of the Internal Revenue Code of 1954 (26 U.S.C.).

The pertinent facts may be summarized as follows: Petitioner provides cold storage facilities for food processors. Between 1973 and 1974, petitioner constructed refrigerated storage facilities which were used for the frozen storage of perishable commodities. No processing takes place in these structures. Food processors deliver frozen fruits, vegetables, and fish to petitioner packed in 64-cubic-foot tote bins, 50-

pound boxes, and cases of 10-ounce packages. Before storage, the containers are marked with a description of the product, a warehouse lot number, and the name of the owner, packer, or distributor. Each processor retains control over its products while stored, and is charged on the basis of quantity (Pet. App. A-3).

On audit, the Commissioner of Internal Revenue disallowed petitioner's claimed investment credit for its cold storage facilities as facilities used for the bulk storage of fungible commodities. Petitioner's position was that food held in tote bins and boxes before final processing was stored in bulk, and the interchangeability of containers within a particular lot made the goods fungible. In this refund suit brought by petitioner in the United States District Court for the Eastern District of California, the district court held that the fact that the goods stored in petitioner's facilities were identified as to the individual owners, who segregated their food and retained total control over its ultimate disposition, destroyed the fungibility of the stored food so that petitioner's facilities were not used for the bulk storage of fungible commodities (Pet. App. C-48 to C-52). It therefore entered summary judgment in favor of the government (Pet. App. D-1 to D-2). The court of appeals affirmed,[1] concluding that the district court's holding was not clearly erroneous. The court also refused to consider petitioner's argument, raised for the first time on appeal, that the cold storage rooms were "giant refrigerators" eligible, as "tangible personal property," for the investment credit pursuant to Section 48(a)(1)(A) of the Code (Pet. App. A-5 to A-7).

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[1] The opinion of the court of appeals (Pet. App. A-1 to A-7) is reported at 659 F.2d 116.

1. The decision below correctly disallowed petitioner's claimed investment credit for its cold storage facilities. The decision below properly applied the applicable Treasury Regulations, Section 1.48-1(d)(5)(ii) (26 C.F.R.), which provides that "property will constitute a storage facility only if the facility is used principally for the bulk storage of fungible commodities. Bulk storage means the storage of a commodity in a large mass prior to its consumption or utilization. Thus, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage." Accord, Rev. Rul. 74-452, 1974-2 Cum. Bull. 11. Here, the record established beyond doubt that the food stored in petitioner's facilities was segregated by owner, thereby destroying the fungibility of the food items and the qualification of petitioner's facility as one for bulk storage. Contrary to petitioner's contentions (Pet. 25-29), the court of appeals therefore properly viewed the district court's ruling as one involving a mixture of facts and law that did not warrant reversal unless shown by petitioner to be clearly erroneous. *Commissioner* v. *Duberstein*, 363 U.S. 278, 291 (1960); *Parkside Inc.* v. *Commissioner*, 571 F.2d 1092, 1095-1096 (9th Cir. 1977).

2. Petitioner further contends (Pet. 15-16) that the court of appeals erroneously refused to consider whether its facilities were in fact "giant refrigerators" and thus were tangible personal property entitled to the investment credit under Section 48(a)(1)(A) of the Code. Petitioner raised this essentially factual argument for the first time in its brief on appeal (Pet. App. A-6 to A-7). It was not mentioned in petitioner's (supplemented) complaint (CR 20, 21E, at 18-25),[2] in its motion for summary judg-

[2] "CR" references are to the docket control numbers assigned by the district court clerk to the documents filed in the case.

ment and accompanying memorandum (CR 17), or in its pretrial statement (CR 18). Accordingly, the court of appeals properly refused to consider it. *United States* v. *Patrin*, 575 F.2d 708, 712 (9th Cir. 1978); accord, *Redwood Empire Savings & Loan Association* v. *Commissioner*, 628 F.2d 516, 521 (9th Cir. 1980). And, contrary to petitioner's assertions (Pet. 17-20), the court of appeals did not depart from these precedents, which approve the accepted practice that "'a federal appellate court does not consider an issue not passed upon below.'" *United States* v. *Patrin*, *supra*, 575 F.2d at 712, quoting *Singleton* v. *Wulff*, 428 U.S. 106, 120 (1976).

Nor does the court of appeals' refusal to consider petitioner's belated tangible personal property argument conflict with *Cooper* v. *Commissioner*, 197 F.2d 951 (4th Cir. 1952), as petitioner contends (Pet. 20-21). In *Cooper*, the Tax Court held that the taxpayer realized ordinary income to the extent his collection of interest claims against a bank exceeded the amount he paid former depositors for these claims. The court of appeals affirmed the Tax Court's holding that the amount realized did not constitute a tax-free gift, and that there had been no sale or exchange of a capital asset. It reversed and remanded the case, however, for further proceedings in which the Tax Court was to consider the possible applicability of Sections 117(e), 117(f) and 23(g)(2) of the Internal Revenue Code of 1939 (26 U.S.C.) (1952 ed.)).[3] The

[3] Section 117(f) of the 1939 Code provided that amounts received upon the retirement of corporate certificates of indebtedness with interest coupons or in registered form were considered received in exchange therefor. Section 117(e) was the five-year capital loss carryover provision, and Section 23(g)(2) was the 1939 Code provision giving capital loss characterization to losses incurred on worthless securities.

remand in *Cooper* was a matter of the court's discretion and is hardly a precedent for mandatory consideration of petitioner's belated argument.[4]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

APRIL 1982

[4] Petitioner asserts (Pet. 29) that the court of appeals "admits that there was an error committed in the lower court." But the court held only that it was not convinced that the district court's findings were clearly erroneous (Pet. App. A-5 to A-6).

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